LEGAL OVERVIEW OF PRIVATE ACTIVITY BOND FINANCINGS

By Stan Raine, Sherman & Howard L.L.C., July, 2007

I. *Parties to private activity bond (conduit) financings and their roles*

A. Issuer: In a conduit transaction, the governmental issuer is both a borrower and a lender. The governmental issuer borrows money from investors by issuing bonds. (For a borrowing to be tax-exempt, the entity that is borrowing money must be a state or political subdivision or a legal entity acting as an "instrumentality" or "on behalf of" a state or a political subdivision.) But in a conduit financing, the governmental issuer is also a lender – it uses the money it borrows from bondholders to lend to other borrowers, and then uses the loan repayments received from those borrowers to repay the bondholders. Depending on the type of loan involved, the governmental issuer enters into various financing documents with the borrower, which may include a loan agreement, a promissory note, a mortgage, insurance guarantees or other security.

B. Underwriter or Placement Agent: The underwriter or placement agent is an investment banking firm that helps structure the bond issue and purchases and resells the bond. If a bank or other investor purchases the bonds directly from the issuer, the transaction is called a private placement rather than an underwriting, and there is no public offering of the bonds. If an investment banking firm helps the issuer place the bonds with the purchaser, it is referred to as a private placement agent.

C. Financial Advisor: Financial Advisors are more frequently used in competitively sold issues, where investment banking firms compete and bid for the right to sell the bonds, rather than negotiate the purchase with the issuer. But they are sometimes used in negotiated issues, as well. The benefit of independent financial advisors is that they act solely on behalf of the issuer. Although there is and needs to be a relationship of trust between the issuer and the underwriter, they are by the nature of their roles at opposite sides of the table as seller and purchaser, and an F.A. can provide an independent financial analysis of what the underwriter is telling the issuer.

D. Bond Counsel: Bond counsel is a law firm with "nationally recognized" expertise in municipal bond transactions. Investors will not buy municipal bonds unless there is an opinion of a recognized law firm to the effect that the bonds are validly issued and (in most cases) the interest on the bonds is tax-exempt. Bond counsel also should be experienced with all aspects of structuring a financing and advises the issuer and the underwriter on the legal aspects of the bond issue

E. Trustee: The trustee's role is to represent and protect the interest of the bondholders and this usually includes holding all funds and other security for the bonds. A Trustee is almost always a commercial bank. The primary agreement signed by the Trustee is the Trust Indenture, but the Trustee may also be a party to other agreements, depending on the nature of the transaction.

F. Borrower: In conduit revenue bond financings, the Issuer issues the bonds not for its own use but to re-lend the bond proceeds to a private party which actually uses the proceeds, such as to finance an affordable housing project or a manufacturing project. The borrower can be a for-profit or a nonprofit entity. In affordable housing rental project financings, the borrower is often a limited partnership or limited liability company organized solely and only to own and operate the project. Most bond and mortgage guarantors (like FHA) require the project owner to be a "single asset" entity, meaning that the owner owns no projects other than the one being financed and conducts no business other than owning and operating the project being financed. This is generally desirable because it minimizes extraneous bankruptcy risks. In affordable housing projects, typically the developer is the general partner and 1% owner with the remaining 99% equity interest sold to the limited partners. This is particularly true in tax credit financings because the limited partners can utilize the tax credits only if they are legally a part owner of the facility.

G. Other parties

1. Disclosure Counsel
2. Underwriter's Counsel
3. Credit Providers
4. Liquidity Providers
5. Remarketing Agent
6. Swap Counterparties
7. Swap Advisors
8. DTC
9. GIC Providers
10. GIC Brokers

II. *Bond Documents*:

A. Indenture (drafted by bond counsel):

1. This is the contract between the Trustee and the Issuer which establishes the details of the bonds. The trust indenture is the most important of the bond documents and includes the form of the bonds. An indenture will include, among other things, the following sorts of provisions:

a. the terms and provisions (maturities, interest rates and redemption rights) of the bonds;
b. the security for the bonds, which may include a project mortgage and a gross revenue pledge;
c. procedures in the event of redemption and defeasance;
d. funds and accounts;
e. permitted investments of moneys;
e. procedures for amending the Trust Indenture;
f. the Trustee's duties and rights; and
g. events of default and remedies.

2. Under the Indenture, the Issuer promises to do several things, including:

a. to cause the principal and interest to be paid on the bonds;
b. to comply with any tax covenants; and
c. to comply with the "program" covenants.

3. The Trustee has several responsibilities as well:

a. to hold all money under the Trust Indenture;
b. to pay principal and interest to bondholders; and
c to act for the bondholders in the event of a default.

B. Financing or Loan Agreement (drafted by bond counsel):

1. This is the agreement, in a revenue bond conduit financing, between the Issuer and the Borrower. Usually, they are called loan agreements, but they are sometimes called financing agreements (like in a Fannie Mae financing), or they may take other forms, such as a lease-purchase agreement or an installment sale agreement. The Loan Agreement generally includes the following:

a. terms and provisions for the loan of the bond proceeds;

b. the agreement of the Borrower to repay the loan in amounts and at times sufficient to enable the Issuer to repay the bonds;
c. security for the Borrower's repayment obligations (like a mortgage on the project being financed, and sometimes some type of third-party insurance or guaranty such as FHA insurance);
d. the Borrower's representations and warranties;
c. promises relating to maintaining, operating and insuring the project;
f. events of default by the Borrower, and remedies; and
g. the Borrower's prepayment rights.

C. Official Statement (drafted by disclosure counsel, if there is one, or by underwriter's counsel): The Official Statement is the document whereby the bonds are offered to potential investors for sale. Under federal securities laws, the Issuer (and the Borrower, if there is one) is obligated to disclose in this document all information that a "reasonable investor" would consider important in deciding whether to purchase a bond, and not to omit any information that a "reasonable investor" would consider important in that decision. A "Preliminary Official Statement," complete except for interest rates and maturities, is often used in the marketing of the bonds.

D. Purchase Contract (drafted by underwriter's counsel): This is the agreement between the Issuer and the Underwriter in which the Issuer agrees to sell the bonds to the Underwriter and the Underwriter agrees to purchase the bonds from the Issuer at a specified purchase price, and under terms and conditions set forth in the agreement. In a conduit transaction, the Borrower is usually a party to this agreement as well. The "BPA" includes provisions for various documents and opinions to be provided by parties to the financing at the closing, including any expected bond rating letters.

E. Credit Enhancement Agreement: This is the document by which a third party insures or guarantees either the bonds or the Borrower's mortgage repayment obligation. This can take the form of bond insurance or a letter of credit, or sometimes a mortgage guarantee.

F. Liquidity Agreement: These are used in connection with variable rate bond issues. They can take different forms, a common form being a Standby Bond Purchase Agreement. In variable or floating rate transactions, the bondholders have the right to put the bonds back for re-purchase at par on seven days' notice. In the normal course, the underwriter (acting as remarketing agent) will remarket those bonds to new bondholders and use the remarketing proceeds to pay the old bondholders. But to provide a backstop in the event that the remarketing agent is unable to remarket the bonds for whatever reason, the Issuer enters into an agreement with a financial institution with a solid short-term rating to provide liquidity to those tendering bondholders, so that the Issuer can keep its promise to pay those bondholders the par price of the bonds on seven days' notice even if the remarketing is unsuccessful. The liquidity provider is also there to provide liquidity for payment of bonds on certain mandatory tender events, such as upon a change in the interest rate modes that are permitted by the Indenture (for example from a weekly rate mode to a daily rate mode, a fixed rate mode, a commercial paper mode or an auction rate mode).

G. Continuing Disclosure Undertaking (drafted by underwriter's counsel): In this agreement, the Issuer, or the Borrower in a conduit financing, agrees to provide ongoing disclosure to the marketplace as required by SEC Rule 15c2-12. These are often called "secondary market" disclosures as distinguished from the "primary" market disclosures made by the Official Statement at the time of the original offering.

H. Investment Agreement: Also sometimes called a "guaranteed investment agreement" or a "GIC," this is the agreement between the Trustee (sometimes the Issuer) and a financial institution in which Indenture moneys are invested at a usually fixed rate and term, subject to withdrawal at any time without penalty when needed by the Trustee or Issuer.

H. Regulatory Agreement (drafted by bond counsel): This agreement is used in rental housing revenue bond conduit issues. It is executed by the Borrower and recorded in the property records to ensure compliance with federal tax law requirements, principally addressing the income limits for tenants.

III. *Volume cap; public hearing and approval*

A. Broadly speaking, tax-exempt bonds are often divided into two types – governmental or essential purpose bonds on the one hand, and private activity bonds on the other. Classic governmental bonds are issued to finance things public facilities like jails, schools and roads, and they also include bonds issued to finance public housing that is owned by the government itself and not a private party. Classic private activity bonds are issued to finance things like a manufacturing facility and privately owned rental housing facilities. They also include types of bonds that one might not necessarily think of as being private activity bonds, programs like single family mortgage revenue bonds and student loan revenue bonds, which benefit the public and not private businesses.

B. One of the rules that apply to most types of private activity bonds, including housing bonds, is the "public approval" requirement. As part of this process, the issuer is required to hold a public hearing (a "TEFRA hearing"), after reasonable public notice, defined to mean publication at least 14 days before the hearing in a newspaper of general circulation within the jurisdiction of the issuer. The purpose of this requirement is to give the general public the opportunity to comment on the proposed bonds and the project being financed. After the hearing and before the bonds are issued, the highest elected official of the issuer is required to approve the issuance of the bonds.

C. Another important rule that applies to most private activity bonds, except those issued as qualified 501c3 bonds or certain types of "exempt facilities" bonds, is what is referred to as the "volume cap" requirement. The purpose of this cap is to limit on an annual basis in each state the federal tax benefit resulting from the issuance of private activity bonds. The principal amount of private activity bonds each year, with some exceptions, cannot exceed the amount of volume cap available in the State. The volume cap for each state is based on its population (subject to a minimum for small states – smaller than Colorado), in an amount equal to $85 per capita. This means that the 2007 limit for Colorado is just over $404,000,000. The Colorado volume cap is allocated each year in accordance with a statute, under which 50% of the volume cap is allocated initially to designated statewide authorities. Most of the remaining 50% is allocated initially to local governments based on their populations, but if a local government would be entitled to less than $1,00,000 (based on $42.50 per capita), it does not receive any volume cap initially. The smallest government to get an initial allocation of volume cap this year was Lafayette, with Brighton just above that, both getting just over a million dollars of cap. The largest, of course, was Denver, which received an allocation of over $24,000,000. (As a reminder, these are not actual dollars, just an allocation of the right to issue private activity bonds up to the amount of the allocation.)

D. An issuer can get additional allocation in two ways – one is by agreement from another government by which it assigns all or some of its allocation to the first government. The other way is to apply for an award from what is called the statewide balance. This consists of the amount of the statewide volume cap that remains unallocated at the beginning of the year (in 2007, just over $20,000,000), plus amounts that are initially allocated but then subsequently relinquished to the statewide balance, either voluntarily or by operation of law. Under the Colorado statute, whatever initial allocation that has not, by September 15 of each year, been used to issue bonds, to assign to another issuer or to "carry forward" for use in a future year, is relinquished to the statewide balance, and there is a round of applications and awards in the Fall based on those amounts.